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NINETY YEARS OF SERVICE
to the Petroleum Industry in the West
1907-1997

May 27, 1997

Minerals Management Service
Royalty Management Program
Rules and Publications Staff
MS 3101, Building 85
Denver Federal Center, Room A-212
Denver, Colorado 80225-0165



Re: MMS Proposed Rulemaking - Crude Oil Royalty Valuation

Gentlemen:

The Western States Petroleum Association (WSPA) appreciates the opportunity to comment on the Minerals Management Service proposed rulemaking on crude oil royalty valuation. WSPA is a non-profit trade association that represents petroleum companies that explore for, produce, transport, refine and market petroleum and petroleum products in the western states. Within the industry the companies affected are varied, and include large integrated companies, small independent oil producers, brokers and purchasers of crude oil and refiners. The MMS proposal would be a fundamental change to a system that involves millions of transactions each year and produces billions of dollars for the U.S. Treasury. As the federal oil and gas leasing program continues to successfully generate huge revenues, certain provisions of the regulations which govern the leasing program are currently being debated. The most controversial at present is how the value of crude oil should be calculated for royalty purposes.

WSPA Position on MMS Proposed Rulemaking

WSPA has reviewed the proposed rulemaking and is opposed to the proposed royalty valuation methodology for California based on index pricing using Alaska North Slope crude oil. WSPA is appreciative of the MMS extension of the comment deadline to May 28, 1997. We take this as 1) a recognition by MMS that the proposed rulemaking has serious implications and 2) a willingness by MMS to continue to work with the stakeholders to understand concerns and work toward equitable solutions.

General Background

Companies calculated the royalties they owe using federal regulations written by the MMS. The value of crude oil and natural gas production on which royalties are paid is determined in accordance with these regulations. For many years most crude oil production has been valued under these regulations based upon gross proceeds for arm's-length transactions and the first applicable benchmark for non-arm's-length transactions.

Recently, MMS has asserted that the valuation of crude oil based on posted prices undervalues the price of oil and results in the underpayment of royalties. As a result, MMS has been looking at alternative ways to value crude oil production. On January 24, 1997, MMS published a notice of proposed rulemaking that would significantly change crude oil royalty valuation procedures. MMS proposes that, for most production, valuation should be based on a market index with adjustments depending on the actual location and quality of production. For most production, the index would be the monthly average of New York Mercantile Exchange (NYMEX) prices. For production in Alaska and California, the index would be Alaska North Slope (ANS) prices.

California's Postings Reflect California Crude Oil Values

WSPA believes that the current posting system in California accurately reflects crude oil values and therefor the use of such postings to determine gross proceeds is reasonable. California crude oil postings are prepared by many companies. Posting companies include not only integrated producer/refiners but also trading companies. Consequently the market is competitive. The presence of many competitors ensures that the producer receives the market value for his crude oil.

Prices for California crude postings are specific to most fields. California postings are specific to each field so that each posting already reflects quality and transportation adjustments appropriate for that field.

California crude oil postings are market-responsive. Comparison of spot prices for Kern River crude oil, a large volume heavy California crude oil from the San Joaquin Valley, shows that postings and spot prices track closely together. Postings for Midway Sunset and Kern River crude oil often are identical. The Chevron postings for Midway Sunset and Kern River were compared over the two year period 1995 and 1996. During that time the difference in postings between the two crudes was exactly zero. Comparisons of Wilmington crude oil postings and THUMS, a spot Los Angeles crude oil, also show that California postings closely track spot market indicators.

The attached plot illustrates that over the past two years spot prices for both Wilmington and Kern River crude oils track postings fairly well. For 1995 the Kern river spot price was on average only three cents per barrel over the postings and was actually below the posting on average for 1996. The THUMS spot price exceeded the Wilmington posting by about \$0.45 per barrel both years. The standard deviations for these data were around \$0.20 to \$0.30 per barrel.

Notwithstanding the accuracy of California's posted and spot crude oil prices, even these accurate market indicators are not a suitable substitute for the existing system of calculating royalties based on gross proceeds. Gross proceeds, or in the alternative royalty in kind, are the only methods that will assure that the proper amount of royalty is paid.

ANS Prices Poorly Reflect California Crude Oil Prices

WSPA believes that comparing ANS crude oil quotations to California heavy oil market indicators show that ANS poorly tracks California heavy crude oil. Even when prices are averaged monthly, ANS prices vary widely from spot California heavy crude oil price quotations. Since California heavy spot quotations and postings track closely together, ANS also correlates poorly to California heavy crude oil postings.

The attached plot shows the difference between Kern River spot price and ANS West Coast price. The average differential is quite large, over \$3 per barrel in 1995 and nearly \$5 per barrel in 1996. The standard deviation was about \$0.75 for 1995 and nearly \$1 per barrel in 1996. The relationship between these two prices varies widely, from as little as \$2 per barrel up to over \$6 per barrel.

California heavy crude oils have quality characteristics that vary widely from ANS. ANS crude oil is typically ten to fifteen degrees API gravity lighter than California heavy crude oils. The value that refiners place on differences in quality varies with time and from refiner to refiner. Factors that influence the variation in value of quality differences include the relative values of light products like gasoline and heavy products like fuel oil.

California heavy crude oils also are subject to market influences not shared by ANS. California crude oils are produced mostly in the Coastal and San Joaquin Valley areas that have complicated systems for delivering the crude to market and many transportation volume constraints. California heavy crude oil that cannot reach markets in California due to pipeline constraints are shipped by pipeline markets east of the Rockies. Variations in demand in regional refineries, pipeline schedule complications, market efforts by international heavy crude sellers such as Venezuela and other factors affect the distribution of California heavy crude oil and prevailing prices relative to other crudes like ANS. Because prices for California heavy crude oil and ANS do not correlate well together, efforts by MMS to link the two are doomed. Even with perfect hind-sight it would be impossible to identify a simple differential or formula as MMS proposes relative to ANS to value California heavy crude oils accurately.

Effects of Proposed Rulemaking

The MMS proposed rulemaking establishes the royalty value of the oil by using the index valuation method discussed in Section 206.102(c)(2). This method will establish royalty value at a much higher level than realized by the producer. Currently, California pipeline barrels are being priced by the market below the value determined by the methodology prescribed by the proposed rulemaking. This is a condition that the producers of crude oil in the state of California can not control. As a result companies will be forced by the new rule to employ the index pricing methodology, even though this is not the basis upon which they are able to realize values for the crude. Simply stated, this rulemaking will require royalties to be paid based on a value greater than the proceeds actually realized by the producing company.

While WSPA members will, of course, continue to honor our lease obligations, it is inevitable that higher royalties associated with artificially high crude prices will affect business decisions regarding future development of these government properties. Properties which are burdened with royalty payments established by artificial values not realized by the producer will not be as attractive for future development. As such, the proposed rulemaking could have a detrimental effect on the total revenue realized by the government.

The effect of the proposed rulemaking will be counter to recent Federal Government actions promoting and encouraging development of existing federal leases. Specifically, the Heavy Crude Royalty Relief Rule and Stripper Well Royalty Relief Rule enticed operators to invest millions of dollars of capital with the understanding that there would be an opportunity to recoup the investment. Investment strategies were based on the conditions of the lease agreements and the royalty determination in place at the time of

investment. Investment strategy in federal properties would have been different had the proposed rulemaking been in effect at the time of the investment. We are very concerned that past investments will not pay out if royalty is calculated by the proposed methodology.

Companies have increased spending to develop federal properties as a result of the royalty relief/reduction. Increased spending by those operating on federal leases has helped stimulate the local economy through new job opportunities and additional activity in the service and supply industries. New jobs and increases in work translate to more taxes being paid to all levels of government. This benefit to the economy is in jeopardy if development on federal properties is affected by the proposed rulemaking.

California heavy crude oils respond to market forces other than ANS. Foreign producers of heavy crude oil such as Mexico and Venezuela have targeted California for some portion of their output. California producers must contend with these crude oils which now enter the California market routinely. The entry of these crude oils into the California marketplace is evidence that California crude oils are not under-priced and that prices for California heavy crude oils are market prices.

California crude oils, like ANS crude oil, are marketed in several distinct markets. California crude oils are processed not only in California refineries but also in refineries east of the Rockies. The average price of California crude at the lease is representative of a complex interplay among these several markets and transportation systems for the crude oil. Generally California crude oils are thought to have higher value in the West Coast market since refineries are better adapted to it and transportation costs are lower.

ANS crude oil is also marketed in several distinct markets. Until recently ANS crude oil was sold not only on the West Coast, but also on the Gulf Coast market. ANS values at the well head were much higher for ANS crude oil sold on the West Coast than the Gulf Coast market because transportation costs were lower. Now ANS also is sold into the Asian market. That market is not as attractive to ANS producers as the West Coast either since transportation costs are higher. Refiners on the West Coast are more accustomed to ANS and their refineries are more attuned to ANS' qualities.

The MMS methodology is based on a gross oversimplification of these complex market patterns. Comparing every barrel of California crude to the ANS West Coast price is no more reasonable than comparing ANS to the ANS West Coast price.

Differential Methodology

In the MMS presentation, no clear methodology was presented for calculating the differential between ANS and California heavy crude oils. The example MMS provided in the testimony had three components, a gravity adjustment, a sulfur adjustment and a transportation adjustment. The MMS has not proposed a reliable differential methodology that, when combined with the price index, accurately reflects the actual value of the crude oil. If such a methodology does not exist or cannot be developed, then the index must be rejected.

There is no evidence that California crude oils are regularly exchanged for ANS crude oil. MMS's ability to provide reliable differentials, even in history, between ANS and royalty crude oil is dependent on the data expected to be available from the Forms 4415. Form 4415 will provide useful information only to the extent that such exchanges actually exist. MMS has not provided any evidence that such exchanges

do, in fact, exist in any volume and has not polled WSPA members to determine if such exchanges occur. Without such exchanges actually occurring in the marketplace, the Forms 4415 will be useless and the MMS proposed methodology will not work.

MMS's position that using ANS spot prices is superior to using Kern River spot prices as an indicator of the value of California royalty crude is incorrect if California crudes are rarely exchanged for ANS. The volume of spot heavy crude oil traded in California is appreciable and is believed to be larger than the volume of heavy crude oil exchanged for ANS. Hence, for purposes of identifying an accurate value of California heavy crude oil, spot figures are representative of more barrels and likely to be a superior indicator of value than the ANS prices.

Form 4415 will not provide new information to MMS. MMS already has access to all transaction data through the audit process. Since MMS already has access to all information, requiring a new data form to be filled out merely adds to the administrative burden of dealing with the federal government without appreciable benefit. This seems counter to the theme of "reinventing government" proposed by the Vice-President.

MMS proposes evaluating crude oil differentials on an annual basis one year in arrears. Even the most pedestrian examination of crude oil markets shows that market movements are far too rapid and volatile to be captured accurately in an annual assessment. MMS has provided no evidence that using whatever data might be gleaned from crude oil transactions in one year will provide an accurate assessment of market value the next year, regardless of how complete the annual data set is or how extensive is the evaluation of the data.

Data for the Forms 4415 can come only from contracts negotiated by the producing companies. Form 4415 would be, in effect, a retrospective simplification of the outcome of the contracts. MMS already has access to not just a simplification but rather the entire contracts in retrospect. If MMS believes that the Form 4415 will provide all the information it needs, MMS proposes to use less information in the future than the past. If MMS believes the actual crude contracts will need to be audited, then MMS is proposing simply another burdensome layer of summary containing no new information, just more forms to audit.

Summary/Recommendations

WSPA encourages the MMS to carefully consider the impacts of the proposed rulemaking. We believe that the proposed rulemaking is detrimental to industry and the government and suggest the current method should be retained unless an equitable alternative can be developed of determining royalty. To the extent the MMS feels that existing gross proceeds methodologies are unacceptable and that taking royalty in kind does not provide relief, then it will be important to consider linking California heavy crude oil to local measures of value that are closely related to California crudes.

The complex changes being proposed by MMS are a radical departure from current regulations, and rest on many assumptions, some expressed and some implied, which have not been made known to stakeholders. The industry believes that fair consideration of the new proposal requires:

- Access to information used by MMS in developing the proposed new valuation system. WSPA supports the American Petroleum Institute (API) Freedom of Information Act request for

additional information that would expand the industry's understanding of the proposal.

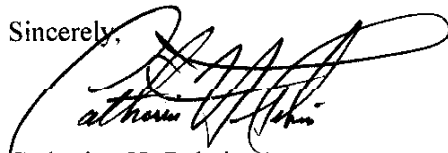
- Continued use of the current rules while possible changes are evaluated. MMS should forego use of any interim final rules which could require substantial-but temporary-changes to industry royalty management systems at great cost.
- WSPA is committed to join with the MMS and other interested parties to continue to understand issues of concern and provide information that continues to demonstrate how existing systems accurately reflect crude oil values at the lease.

WSPA remains very concerned about the proposed rulemaking. The proposed rulemaking would require royalties to be paid on values in excess of proceeds received and potentially affect the future development of federal properties. We trust that these comments will be given serious consideration as the proposed rulemaking will have a significant adverse economic impact on current and future operations of our clients.

The federal minerals leasing program has generated huge revenues for the U.S. Treasury, benefiting taxpayers by reducing the federal deficit and financing conservation, parks and historic preservation programs. A well-administered leasing program provides the climate for a healthy, growing industry - one that provides domestic oil and gas supplies needed by a vibrant economy and that creates American jobs.

If you have any questions or need additional information, please don't hesitate to contact me at (916) 498-7752.

Sincerely,

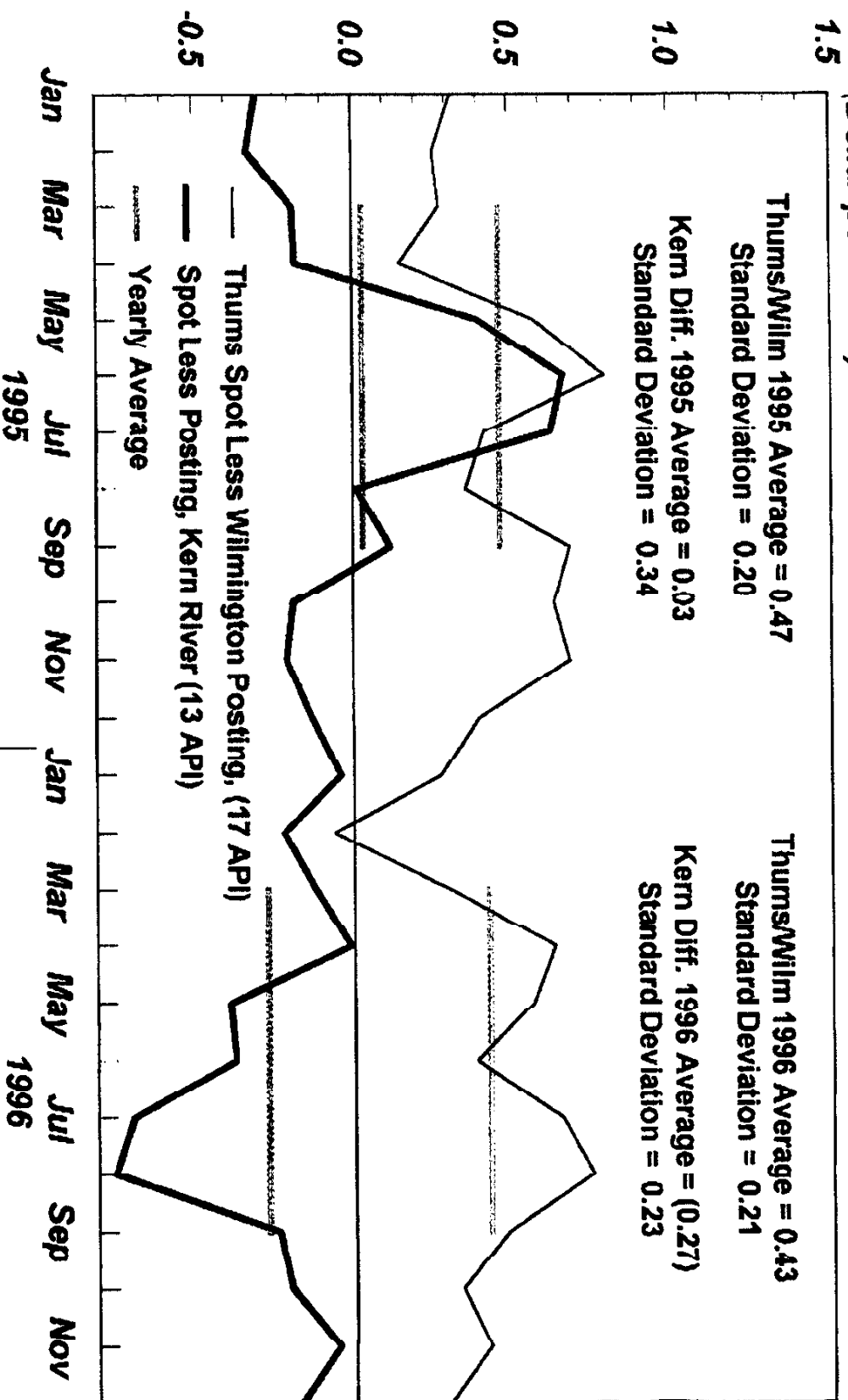


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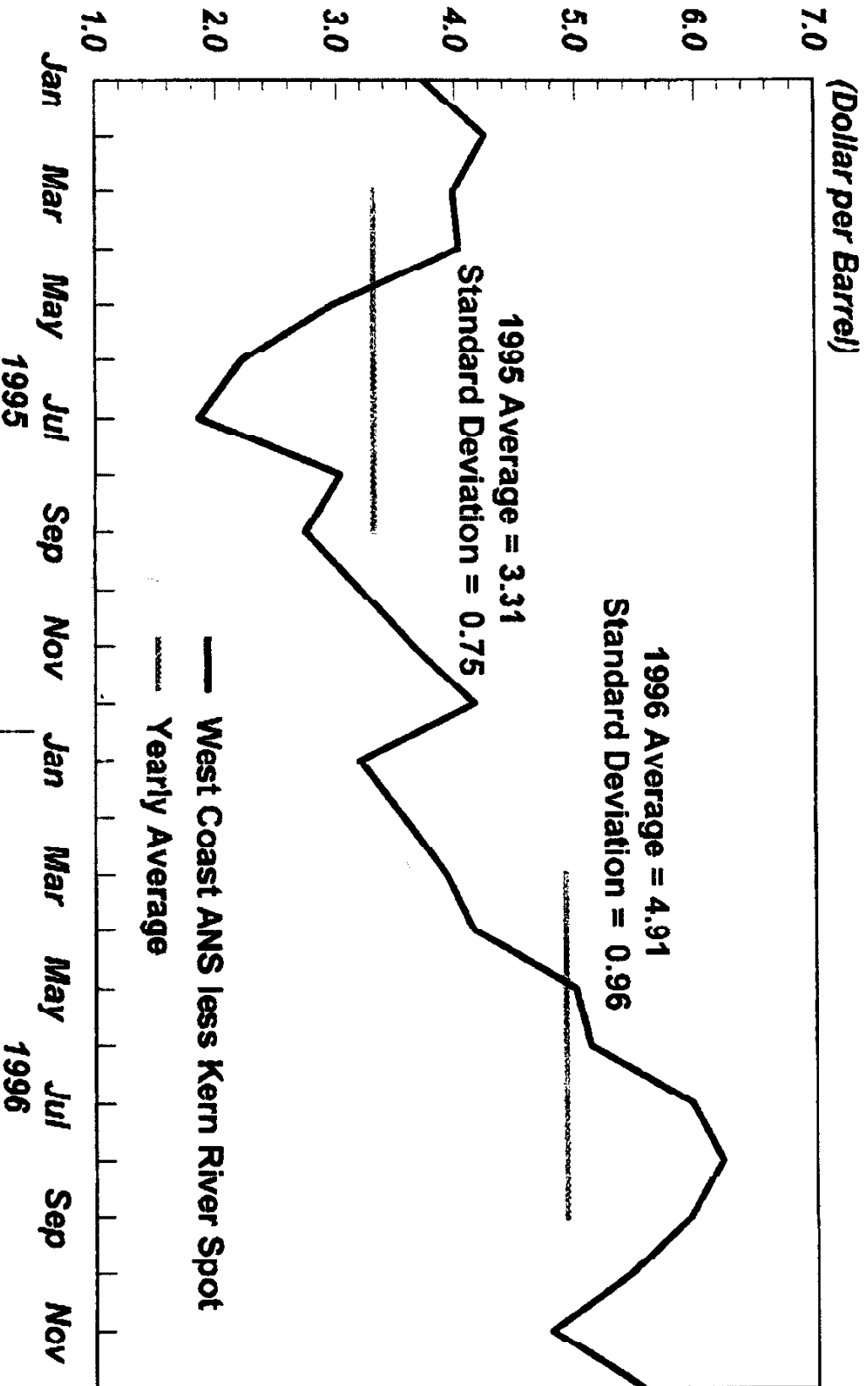


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WEST COAST CRUDE DIFFERENTIAL



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